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C O N F I D E N T I A L ZAGREB 000627

SIPDIS

E.O. 12958: DECL: 04/08/2013
TAGS: ECON EFIN PREL HR
SUBJECT: THE ECONOMY -- SANADER GOVERNMENT'S ACHILLES HEEL?

Classified By: Economic Officer Isabella Detwiler: Reason: 1.5 (B AND D
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Summary

¶1. (C) While the Sanader government has scored points on the foreign policy and political fronts, it is faltering on the economic front. The government inherited certain economic weaknesses, further handicapped itself with slavish campaign promises, then shot itself in the foot with weak appointments to economic positions. While the government has been forced to recognize that it needs an IMF program, it does not appear to have a strategy on how to make the painful changes necessary for a new Standby Arrangement. Despite the grumbling of economists and citizens, the markets remain unfazed. End Summary.

Good news/Bad news: Economy Cooling

¶2. (C) While the IMF and the previous government maintained until late into the year an estimate for 2003 GDP growth of 5 percent, no one was too surprised when it turned out to be 4.4 percent. The incoming government's official and conservative estimate for 2004 of 3.2-3.4 percent also reflects the consensus that the economy is cooling. That should be good for the current account deficit and mounting foreign debt, but as the government's macroeconomist in the Ministry of Finance conceded, growth in this range is not enough to continue to pull down the unemployment rate. And there is no guarantee that the economy will not slow down too fast or too far. (On a positive note, unemployment has continued to fall, and despite claims to the contrary, the number of registered unemployed was 10 percent lower in February 2004 than a year earlier.

¶3. (C) The lower-than-projected growth was not the only bad news at the end of year. For reasons that remain murky, the budget was blown in the last few months of the year, mainly after the election, but before the new government took over. Some "overspending" was due to the current government's push to classify as much spending as 2003 spending as possible in areas where there was accounting leeway. Other overspending was due to good weather, which allowed the acceleration of road construction. It also appears that the government accelerated the payment of some bills. The net effect was that the final deficit came in a full percentage of GDP over the target of 4.5 percent.

¶4. (C) Paradoxically, the ratio of government debt to GDP has stabilized at about 52 percent, while the foreign debt (combined public and private) has continued to soar -- 76 percent of GDP at the end of 2003, and climbing. While, as the Central Bank governor pointed out last year, some of this "private" sector borrowing may actually be state-owned companies, much of the new debt is a result of local subsidiaries of foreign-owned banks bringing in funds to fuel a consumption-led boom. Administrative measures by the Central Bank last year to slow the growth in credit by using reserve requirements to penalize banks that lent too much appear to have been widely circumvented. "Loans" became "leases" and larger corporate borrowers simply borrowed directly from abroad.

¶5. (SBU) The current account deficit is showing some signs of improvement, but not as rapidly as everyone would like. The figure for 2003 is a scary sounding 7.2 percent, but reportedly includes a large (1.1 percent of GDP) one-off accounting entry, which the Central Bank argues means the "real" deficit was "only" 6.2 percent, just a bit over the target of 6.0 percent, and much lower than the 8.5 percent of ¶2002. However, the trade deficit continues to increase, and the economy remains dangerously dependent on strong tourist seasons to lower the current account deficit.

¶6. (C) The Central Bank has been talking up the need for the government to use fiscal policy to rein in demand, claiming that as an open, euro-ized economy, monetary policy would be ineffective in Croatia. Nevertheless, the Central Bank has been working with the IMF on a package that would combine an increase in interest rates with tools to prevent excessive inflows of capital.

The SBA is Dead; Long live the SBA

¶7. (C) It became clear early this year that the current precautionary Standby Arrangement with the IMF was dead, with most of its targets blown by larger or smaller margins. But with a new government in power, newly convinced (by the EU) of the wisdom of maintaining and negotiating a new SBA with

the Fund, the IMF found it hard to "punish" anyone. The early-March announcement that the SBA was off-track, carefully orchestrated by the government and the IMF to minimize "panic," was greeted by a collective yawn by international markets.

¶8. (C) While PM Sanader has decreed that there will be a new Standby Arrangement, it is unclear whether he is willing to make the sacrifices to reach one. Negotiations on a new SBA should begin the second half of April, with a Board meeting in the late summer. While the IMF appealed to the government during the visit of the country director in February not to make fiscal decisions that would hem the government in, the government has forged ahead with a relatively loose budget, delivering partially on expensive pension promises, and moving a step closer to an expensive tax cut.

¶9. (C) Part of the government's determination to attribute as much spending as possible to the previous government was to establish a high base from which to "decrease" government spending. To a certain degree, this has worked. Before the budget was passed in early March, the IMF told us that it would not support a spending level of 4.5 percent for 2004, since the previous SBA had targeted a deficit of only 3.8 percent. At this point, the IMF appears to have given up on further cuts this year, but is aiming for an ambitious 3.7 percent in 2005.

One-Two Punch to the Budget

¶10. (C) Despite the government's professed right-of-center orientation, the military and police arguably got short shrift in the budget process. Social spending was the most lavish, as the government delivered on promises it made to the pensioners' party to secure the support of its three seats in the Parliament. Health and road construction were also winners, while increased spending on railroads was delayed for at least one year (although there are rumblings that some spending may be restarted).

¶11. (C) The most distressing development, because of its long-term impact and the political difficulty of reversing it, is the set of changes made to the pension insurance law in March. The legislation formalized a change in the indexation of pensions from a price-wage index to an index based solely on nominal wage increases, as well as an increase to the base pension. The tax exemption for pensioners was also increased. These changes alone will increase government spending on pensions by 23 billion kuna (about $3.8 billion) over ten years, by GOC estimates. It would reverse the previous downward trend in spending on pensions as a percent of GDP, increasing spending by almost two percent of GDP by 2013. And this is only part of the package promised by Sanader.

¶12. (C) The government has promised to submit to Parliament by June a package further sweetening the pensions. Indexation would be raised again, to a combined index using wage and nominal GDP increases, plus a payment of the so-called "pensioners debt," which the past government had successfully (at least legally) settled. The stated aim of the package is to bring the average pension to 70 percent of the average wage. This would be incredibly generous by almost any standard and would gut the recent pension reform, which sought to shift people from a failing "pay-as-you-go" system to individualized retirement accounts.

¶13. (C) The problem is particularly acute because of the large number of people on pensions -- an incredible 1.1 million out of a population of 4.4 million and a workforce of only 1.7 million. The average net pension is less than 2000 kuna, or $350 dollars, which, while not bad by area standards, makes arguments that pensions need to be curbed politically difficult.

¶14. (C) Further complicating the task of lowering the deficit and reaching an agreement with the IMF is the VAT cut, brainchild of key Sanader advisor Ante Babic. This will cost up to 3 billion kuna. The cut has surprisingly few supporters. Consumers are skeptical the cut will translate into lower prices, economists are skeptical it will stimulate business, and even some government officials have indicated to us they would have preferred to see a cut in payroll taxes to increase competitiveness. Despite the lack of popular support, the parliament took a step in the direction of no-return when it passed a law April 2 that committed the government to lower the VAT rate from 22 to 20 percent

beginning January 2005. So far, efforts to collect additional revenues from administrative reform and improved tax collection -- identified by Babic as sources to make up the shortfall -- appear not to have even gotten off the

drawing board.

Shallow Talent Pool

¶15. (C) The economic team -- if it can be called that -- does not seem to be functioning. As far as we can tell, there is little coordination. Deputy Prime Minister in charge of the economic portfolio, Dr. Andrija Hebrang, does not have a background in either economics or in business. He is embroiled in almost daily battles with the media and the medical establishment on issues arising from his "other job," as Minister of Health. Ante Babic, State Secretary in the Prime Minister's office for Strategic Development, and self-described "mastermind" of the Sanader government's economic policy, appears to be increasingly side-tracked. After authoring the VAT reduction, the idea to enforce central procurement of local input for state-owned shipyards, and failing to prevent the giveaway to pensioners, that may be just as well. Finance Minister Suker at least has budget hawk instincts, but as a small town mayor and tax collector, may not have the inclination or ability to form broader economic policy.

¶16. (C) Thus the responsibility has had to flow up, to Sanader, and down, to State Secretary of the Ministry of Finance, Martina Dalic. Dalic headed the macroeconomist department of the Ministry in the previous government, then left to become the chief economist at the Croatian branch of Raiffheisen Bank. She is well-respected and has shown formidable determination and vigor in trying to whip the dysfunctional Ministry of Finance into shape. However, in addition to her other duties, she is now effectively in charge of both IMF and World Bank negotiations (Babic having been sidelined from the latter). It is doubtful that she has the political weight to demand concessions from Ministers. Thus, important decisions will have to be backed by her Minister, and in most cases, the Prime Minister.

¶17. (C) Meanwhile, Minister of Foreign Affairs Zuzul has done more to promote Croatian exports and investment in Croatia than the "invisible" Minister of Economy Branko Vukelic. The problems in the Ministry of Economy extend downward -- key positions have been filled with weak candidates, and experienced staff let go. A strong Minister of Transport and Infrastructure, Bozidar Kalmeta, will probably be good for Croatia's infrastructure development, but left unchecked, could put even more strains on the budget. Preliminary signals from our EC counterparts indicate that the new Minister of EU Integration -- whose ministry has some influence on the pace of overall reforms -- Kolinda Grabar-Kitarovic, may be having difficulty filling the large shoes of her predecessor.

Comment

¶18. (C) Croatia has had a weak economic team for years, yet still experienced respectable economic growth. It is too early to say that the good luck has run out. However, it is clear that the bad decisions of the last few months could be the seeds of future crisis if left uncorrected. The IMF will play a key role in giving the government cover to reverse itself; one question is whether the IMF can or should bend enough to reach an agreement with which the Sanader government can live, given the HDZ's lack of a majority in the parliament. The World Bank, for now, is insisting that the government conclude an SBA with the IMF in order for the government to access the goodies of the Programmatic Adjustment Loan. Meanwhile, as the GOC has recently found on a bond-selling road trip that the markets continue to smile on Croatia, delaying the day of reckoning.

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